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Supreme Court of the United States

October Term, 1949.

KENTUCKY TRUST COMPANY, Executor of the Estate of Martin L. Schmidt, - - Petitioner,

versus

SELDEN R. GLENN, - - - - Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

AND

BRIEF IN SUPPORT THEREOF.

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KENTUCKY TRUST COMPANY, EXECUTOR OF THE ESTATE OF MARTIN L. SCHMIDT, - *Petitioner,*

v.

SELDEN R. GLENN, - - - - *Respondent.*

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

To the Honorable, the Supreme Court of the United States:

Your petitioner respectfully shows:

I.

SUMMARY STATEMENT OF THE MATTER INVOLVED.

This case challenges the extension of the doctrine of *Helvering* v. *Clifford,* 309 U. S. 331, to an irrevocable long-term trust which the settlor had no right to amend or modify and in which he retained no interests, had no rights to income or reversion, could not have the income or corpus used to relieve him of any obli-

gations of support, and retained no powers over the trust for his own benefit.

This action was originally instituted by Martin L. Schmidt to recover from the respondent income taxes paid by Mr. Schmidt on income received by two trusts established by Mr. Schmidt for the benefit of his son and daughter. The petitioner is the personal representative of Mr. Schmidt and is his successor in interest.

On December 10, 1938, Martin L. Schmidt, hereinafter called the settlor, created two trusts, with a corporate trust company as trustee.[1] One trust was for the benefit of his son, then nineteen years of age, and the other for the benefit of his daughter, then twenty-one years of age. Neither trust could be amended. Both were irrevocable and without any reversionary interests in the settlor. The income from the trusts was to be accumulated until the beneficiaries were respectively twenty-five years of age. After the beneficiaries had attained that age, the income was to be paid over to them, until they were forty years of age. At the latter date, the trusts were to terminate and the entire corpora of the trusts were to be paid to the beneficiaries or their descendants. Neither the income nor the corpora of the trusts could be used to relieve settlor of his legal duty to support the beneficiaries.

Paragraph IV of each trust instrument provided in part:

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[1] T. R. 26.

> "During the lifetime of Donor, the Trustee is authorized, empowered and directed to lease, mortgage, pledge, sell, dispose of, invest and reinvest property so held by it, and to vote stocks, exchange one class of securities for another, and agree to compromises with reference thereto only at such times and in such manner as may be authorized and directed by Donor in writing."

On December 10, 1938, the day the trusts were created, the settlor transferred to the trustee two hundred shares of stock in Coca-Cola Bottling Company of Louisville, Inc. under the trust for his daughter, and two hundred shares of such stock under the trust for his son (Stipulation, par. 4, T. R. 23). The settlor at that time was president of the Coca-Cola Bottling Company of Louisville, Inc., having held such position since 1925 (T. R. 66).

On December 28, 1940, appellant transferred fifty additional shares of Coca-Cola Bottling Company stock to the trustee under the trust for his daughter and fifty additional shares of such stock to the trustee under the trust for his son (Stipulation, par. 5, T. R. 23). No other additions were ever made to the corpus of either trust, and no reduction, withdrawal or substitution was ever made in the corpus of either trust (Stipulation, par. 7, T. R. 23).

The following table shows the shares of stock of the Coca-Cola Bottling Company (Joint Exhibit 3-C, T. R. 42) owned by the settlor and the percentage of total stock owned by the settlor and the trusts throughout the taxable years involved:

SHARES OF STOCK OWNED.

OWNED BY	Immediately Prior to Creation of Trusts on Dec. 10,1938	Immediately After Creation of Trusts on Dec. 10, 1938	Dec. 27, 1938	Aug. 31, 1940	Dec. 27, 1940
Martin L. Schmidt...	800	400①	620②	600③	500④
Trusts	...	400	400	400	500
Total	800	800	1020	1000	1000

PERCENTAGE OF TOTAL STOCK OWNED.

OWNED BY	Immediately Prior to Creation of Trusts on Dec. 10,1938	Immediately After Creation of Trusts on Dec. 10, 1938	Dec. 27, 1938	Aug. 31, 1940	Dec. 27, 1940
Martin L. Schmidt...	19.048%	9.524%①	14.762%②	14.286%③	11.905%④
Trusts	.....	9.524	9.524	9.524	11.905
Total	19.048	19.048	24.286	23.810	23.810

EXPLANATION

① 200 shares transferred from Martin L. Schmidt to trust for Martha K. Schmidt and 200 shares from Martin L. Schmidt to trust for Martin F. Schmidt, December 10, 1938.

② 220 shares received by Martin L. Schmidt from Lily J. Schmidt Estate, December 27, 1938.

③ 20 shares transferred from Martin L. Schmidt to Martin F. Schmidt, August 31, 1940.

④ 50 shares transferred from Martin L. Schmidt to trust for Martha K. Schmidt and 50 shares from Martin L. Schmidt to trust for Martin F. Schmidt, December 27, 1940.

The settlor was moved to create the trusts out of a desire to provide as fully as he could for the economic security of his children (T. R. 74, 75). It was his desire to create a separate estate for his children which would consist of Coca-Cola Bottling Company stock, and in this connection he wished to divest himself fully and finally of this property (T. R. 75). He selected the medium of a trust for this purpose, instead of making simple gifts of the stock, because his children were inexperienced in business affairs and

needed the advice and counsel of a reputable trust company which would act as trustee and supervise the investment of the trust property and income (T. R. 76).

The provision regarding the settlor's right to direct investments and the voting of stocks was inserted in the trust instruments solely for the benefit of the beneficiaries (the settlor's children) (T. R. 75, 78). The settlor believed that at some future time a situation would arise where his superior judgment regarding the purchasing, selling or holding of Coca-Cola Bottling Company stock would be of benefit to the trustee and beneficiaries (T. R. 78).

The settlor had been associated with the Coca-Cola Bottling Company continuously since 1902 and had been president of the company since 1925 (T. R. 66). By virtue of over forty years close association with the company, he had the opportunity to become fully acquainted with the business and affairs of the company and its prospects for future development and growth. He had the opportunity to form sound judgments with respect to the value of the company's assets and its business prospects (T. R. 69). The trustee, on the other hand, was a large corporate trust company whose investment committee was occupied with the management of many trust funds and had little time or opportunity thoroughly to acquaint itself with the fortunes of a small, closely held local business concern (T. R. 78). Because of this situation, the settlor believed he was in a position which would enable him, better than the trustee, to know just when the stock

of this corporation was a good investment, how it should be voted, when it should be sold and when it should be held (T. R. 78). He was in a position to exercise sound judgment with respect to such matters, and he wished to afford the trustee and the beneficiaries the advantage of such judgment (T. R. 78). For this reason, the provisions relating to the power of the settlor to control trust investments and vote trust stock were inserted in the trust instruments (T. R. 78).

The settlor never transferred any assets to the trusts except stock of Coca-Cola Bottling Company (Stipulation, par. 7, T. R. 23).

The stock of the Coca-Cola Bottling Company was owned two-thirds by the settlor, his mother, his wife, his son, the trusts and his two brothers and their families, and one-third by the Ewing, Hurlbut and Nieland families, of Chattanooga, Tennessee (T. R. 69-70, 83). Relations between the Schmidts and the Ewings, Hurlbuts and Nielands were always harmonious (T. R. 73). There was never any contest or disagreement among the stockholders regarding the election of directors or about anything pertaining to the company's business (T. R. 70).

During the taxable years here involved the settlor made no suggestions and gave no directions to the trustee with respect to the investment of trust funds or voting of trusteed stock (T. R. 91, 97-98).

During the period here involved, the settlor was a man of ample means. His resources in his individual capacity were sufficient to enable him to discharge all of his duties of support to his children. He paid for

their expenses during this period from his independent funds (T. R. 82).

The Commissioner of Internal Revenue determined that the incomes from the aforesaid trusts were taxable to the settlor, and, for the years 1939, 1940 and 1941, required the settlor to pay to respondent, as a result of such determination, taxes on such income. The settlor then filed suit in the District Court of the United States for the Western District of Kentucky against respondent for refund of these taxes. Trial was had without a jury and thereafter the court decreed that the settlor's complaint be dismissed on the merits, holding that the incomes of the trusts were taxable to settlor under Section 22(a) of the Internal Revenue Code (Appendix, *infra,* p. 31) and the doctrine of *Helvering* v. *Clifford,* 309 U. S. 331. Upon appeal to the United States Court of Appeals for the Sixth Circuit, that court ordered that the judgment of the district court be affirmed. A petition for rehearing was denied.

While the petition for rehearing was pending in the United States Court of Appeals for the Sixth Circuit, the settlor died. Petitioner was appointed the settlor's executor on March 21, 1949. On May 26, 1949, pursuant to motion by petitioner, the United States District Court for the Western District of Kentucky ordered that petitioner be substituted for the settlor as a party in this action.

II.

STATEMENT DISCLOSING BASIS OF THIS COURT'S JURISDICTION.

The decree of the United States Court of Appeals for the Sixth Circuit, a review of which is here sought, was entered February 15, 1949 (T. R. 155); a petition for rehearing was denied March 14, 1949 (T. R. 175), and an extension of time to and including August 1, 1949, for filing this petition was granted by this Court on May 28, 1949.

The statutory provision relied upon to sustain the jurisdiction of this Court is ~~Section 240 of the Judicial Code as amended by the Act of February 13, 1925 (28 U.S.C.A., Section 347).~~ Title 28 U.S. Code, Sec. 1254.

III.

QUESTIONS PRESENTED.

There is only one question involved in this petition:

Is the income of two long-term, irrevocable trusts for the benefit of settlor's children wherein the settlor had no reversionary interest and wherein he retained, solely for the benefit of the trusts and the beneficiaries and not for any advantage to him, only certain managerial powers consisting of the right to direct the trustee with respect to the investment of trust funds and the voting of stocks held by the trusts, taxable to the settlor under Section 22(a) of the Internal Revenue Code and Section 29.22(a)-21(e) of Treasury Regulations 111, as amended.

IV.

REASONS RELIED ON FOR ALLOWANCE OF THE RETURN.

1. The holding of the court below allows the collection of an income tax by the United States from a person who does not own the income upon which the tax is levied and who cannot receive any economic benefit from such income. The construction of the revenue laws of the United States so as to support such a collection of tax is submitted to be in violation of the direct tax provisions of Article I of the Constitution of the United States and of the exception to those provisions set forth in the Sixteenth Amendment.

Petitioner recognizes that this Court has determined that a settlor of a trust who retains powers over the trust which can be employed for his own economic gain can be lawfully taxed on the income of such trust. *Helvering* v. *Clifford,* 309 U. S. 331. The court below, however, has extended that doctrine to a settlor whose retained powers cannot be employed for his own economic advantage. Relief from this Court is sought in preventing this infringement of settlor's constitutional rights.

2. The aforesaid constitutional question was decided by the United States Court of Appeals for the Second Circuit contrariwise to the decision of the court below. The conflict between the Circuits on this point should be resolved by this Court.

3. The decision below is in conflict with the decision of this Court in *Helvering* v. *Clifford,* 309 U. S. 331. This Court there established the principle that the settlor of a trust is taxable on the income thereof if, but only if, the terms of the trust and the settlor's reservation of control over its corpus leave his economic position substantially unchanged after the trust's creation. But here the court below decreed taxability to the settlor on the basis of powers retained over the trusts which could in no way afford economic benefits to the settlor. In so doing, it departed from this Court's holding on that issue. This departure should be corrected by this Court.

4. Subsequently to the taxable years here involved, the Treasury Department promulgated regulations implementing the doctrine of *Helvering* v. *Clifford,* which, if applied to the settlor, would render him not taxable on the income from the trusts here involved. Although the Treasury Department has stated that retroactive application of such regulations will be carried out in the administration of the revenue laws, nevertheless the settlor was denied the benefits of such regulations by the court below. The settlor is entitled to have his taxability determined according to these regulations. The validity and retroactive application of the aforementioned regulations have not been, but should be, determined by this Court.

5. The questions decided by the court below are important questions of federal law which have not been, but should be, decided by this Court.

V.

PRAYER FOR WRIT.

WHEREFORE, your petitioner respectfully prays that a writ of certiorari issue out of and under the seal of this Honorable Court, directed to the United States Court of Appeals for the Sixth Circuit, commanding that court to certify and send to this Court for its review and determination a full and complete transcript of the record and all proceedings of that court had in this case, which is numbered and entitled on its docket 10,747, *Martin L. Schmidt, Appellant* v. *Selden R. Glenn, Appellee,* to the end that this cause may be reviewed and determined by this Court; that the judgment of that court be reversed, and for such further relief as to this Court may seem proper.

KENTUCKY TRUST COMPANY,
EXECUTOR OF THE ESTATE
OF MARTIN L. SCHMIDT,
Petitioner,

By JAMES E. FAHEY,
Louisville, Kentucky,
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WILLIAM A. MACKENZIE, JR.,
Of Counsel.

Supreme Court of the United States

October Term, 1949.

No. _____.

KENTUCKY TRUST COMPANY, EXECUTOR OF THE ESTATE OF MARTIN L. SCHMIDT, - *Petitioner,*

v.

SELDEN R. GLENN, - - - - *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I.

OPINIONS BELOW.

The opinion of the District Court (T. R. 125) was entered January 20, 1948, and is reported in 75 F. Supp. 865. The judgment of the United States Court of Appeals for the Sixth Circuit (T. R. 155) was handed down February 15, 1949, and is reported in 172 F. 2d 863.

II.

STATEMENT OF THE CASE.

The statement appearing at pages 1 to 7 in the petition for writ of certiorari is hereby adopted and made a part of this brief.

III.

SPECIFICATION OF ERRORS.

Petitioner intends to urge and rely upon each of the following errors assigned to the decree of the United States Court of Appeals for the Sixth Circuit:

1. The court erred in not reversing the decision of the district court.

2. The court erred in holding that the settlor reserved to himself powers over the trusts here involved to such an extent as to bring the trusts within the principle of *Helvering* v. *Clifford,* 309 U. S. 331.

3. The court erred in not holding that economic benefit to the settlor from the reservation of powers over the trusts must be considered in determining the taxability of the settlor on the income of the trusts.

4. The court erred in not holding that, in determining whether powers over the trusts reserved to settlor, as grantor, are reserved for the benefit of the settlor or the beneficiaries, the terms of the trust and all the circumstances attendant on its creation and operation must be considered.

5. The court erred in not holding that for the settlor to be taxable on the income of the trusts he must receive, or be able to receive, economic gain through the exercise of retained powers over the trusts.

6. The court erred in not holding that the Treasury Regulations which implement the doctrine of *Helvering* v. *Clifford* render the settlor nontaxable on the income of the trusts, and in not holding that such regulations are applicable to this case.

IV.

ARGUMENT.

The Decision of the Court Below To Allow Taxation of the Trust Income To the Settlor Violates the Settlor's Rights Under the Federal Constitution.

In *Helvering* v. *Clifford,* 309 U. S. 331, this Court held that the settlor of a trust could be charged with income taxes on income received by the trust where the trust was of short duration with reversion of the trust property to the settlor, the beneficiary of the trust was the settlor's wife and the settlor retained substantial control over the corpus of the trust.[1] This

[1]In that case the taxpayer transferred to himself as trustee certain securities which he owned. All the net income from the trust was to be held for the exclusive benefit of the taxpayer's wife. The trust was for a term of five years, except that it would terminate earlier upon the death of either the taxpayer or his wife. On termination of the trust the entire corpus was to go to the taxpayer. During the continuance of the trust the taxpayer was to pay over to his wife the whole or such part of the income as he in his absolute discretion might determine. And during that period he had full power to exercise all voting powers incident to the trusteed shares of stock, to exercise absolute control over the property in the trust and over its investments and to hold property in the trust estate in names of other persons, including his own name. An exculpatory clause protected the taxpayer from all losses except those

Court concluded from these circumstances that the settlor, after establishing the trust, retained full enjoyment of all the rights which he previously had enjoyed with respect to the property composing the trust and that he was none the poorer by virtue of the trust's creation.

We conceive that the rationale of the *Clifford* decision is that it must be determined that the settlor's economic position remains substantially unchanged as a result of the creation of the trust before trust income can be taxed to him. In this case, the district court found from the evidence that the administrative control retained by the settlor was calculated to enable him to add his superior knowledge of the affairs of the Coca-Cola Bottling Company and the value of its stock to that of the trustee for the best interests of the trusts, and that the conduct of the settlor in connection with the operation of the trusts demonstrated that he did not retain powers of control for his selfish interests.[2]

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occasioned by his own wilful and deliberate breach of duties as trustee. It was also provided that the taxpayer's wife could not transfer, encumber, or anticipate any interest in the trust or any income therefrom prior to actual payment thereof to her.

Under these circumstances, this Court held that the grantor, after the trust had been established, could still be treated as the owner of the corpus and the income therefrom for tax purposes and that the trust income was to be taxed to him under Section 22(a) of the Internal Revenue Code.

[2] T. R. 133, 134. In its original memorandum, the district court found as facts only such facts as were stipulated by the parties, ignoring the entire record made on the trial by the taxpayer's witnesses. Much of the factual matter which was brought out by the taxpayer's witnesses, however, is embodied in the court's original memorandum under the heading *"Conclusions of Law."* Petitioner feels, however, that whether findings of fact are actually denominated as such or placed under a heading *"Conclusions of Law"* is not material where it is evident from a reading of the memorandum, as it is here, that the court made certain definite factual determinations.

When the settlor's administrative powers over the trust property are viewed in the light of these findings, it is submitted that taxation of trust income to the settlor in this case presents an unwarranted extension of the doctrine of *Helvering* v. *Clifford,* because it cannot be said in any sense that the settlor retained "the substance of full enjoyment"[3] of all the rights which he previously had enjoyed with respect to the property. The trusts here were long-term trusts with no reversionary interests, or even a possibility of reverter. No power existed in the settlor to amend them. The trustee was an old, established trust company. As set forth above, the administrative control retained by the settlor over the trust properties cannot be said to place in the settlor's hands such dominion over the properties as to leave his economic position unchanged, since this control was retained by him solely to afford him the opportunity of exercising his superior knowledge of the affairs of the Coca-Cola Bottling Company for the benefit of the beneficiaries and, therefore, had to be exercised exclusively in their best interests.[4]

Even were it not completely established that settlor retained administrative control over the trust properties for the benefit of the beneficiaries, he could not be said to have retained the "substance of full enjoyment" of the trust properties as that term is used in the *Clifford* decision. Under the provisions of the trust instruments, he could not have sold or disposed

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[3]Helvering v. Clifford, 309 U. S. 331, 336 (1940).

[4]Cushman v. Commissioner, 153 F. 2d 510 (C.C.A. 2d, 1946). See also the opinion of the district court, T. R. 133, 134.

of any of the trust properties or directed the investment of any trust funds without regard to the fair values of the properties involved.[5] Further, the percentage of stock owned by the trusts when coupled with that owned by the settlor, individually, could not possibly have effected any control of the corporation involved. Therefore, the settlor's right to direct the voting of trusteed stock was without significance.[6] Mr. Schmidt and the trusts together at no time owned as much as one-fourth of the total Coca-Cola Bottling Company stock outstanding. The stock of the company was held by a few individuals, and more than ninety per cent of it was represented and voted at every stockholders' meeting during the years involved.[7] The control of less than twenty-five per cent of this stock could not have significance.

The Government, in its arguments to the courts below, made much of the fact that Mr. Schmidt's family, together with his brothers and his in-laws, owned two-thirds of the company's stock. But the Schmidts' control amounted to fifty-seven and one-sixth per cent without the trusteed stock.[8] Furthermore, the adding together of stock ownership of the Schmidt tribe is a totally unrealistic approach to the problem of the significance of the right to vote the trusteed stock. Mr. Schmidt had no right or authority to direct the voting of any of the stock held by the members of his family. The Government, in many situations, notably

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[5]See district court opinion, T. R. 133.
[6]Table *supra*, page 4.
[7]T. R. 71-73; Plaintiff's Exhibit No. 1, T. R. 100.
[8]Table *supra*, page 4.

the family partnership cases, has sought to restore for tax purposes the jural indissolubility of the family to the position it occupied in archaic law. But even in such cases, the family group was confined to spouses and lineal descendants. Here, the effort goes much further—brothers and sisters-in-law, nieces and nephews, are embraced. Such tribal solidarity, as apart from family solidarity, has not yet been adopted as a tenet of our tax law.[9]

In view of the district court's findings regarding the reservation of power for the benefit of the beneficiaries and the consequent lack of economic gain to the settlor from these retained powers, it must be considered that the court below has necessarily ruled that the issue of benefits to the settlor, and hence the factor of "change in his economic position,"[10] was not determinative of the question whether the trust income should be taxed to the settlor. Under the decision of the court below, any retained administrative powers, regardless of their effect on the settlor's economic position in respect of the trust property, renders trust income taxable to the settlor. This, we submit, is directly contrary to the decision of this Court in the *Clifford* case, and is clearly violative of the settlor's rights under the constitution.

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[9]Not even the stock owned by Mr. Schmidt's wife (8.09 per cent of the total outstanding, T. R. 42) should be considered. The history of divorce courts and the modern tendency toward recognition of separate legal rights in wives oppose such an approach. See Ward Wheelock, 7 T.C. 98 (1946).

[10]Helvering v. Clifford, 309 U. S. 331, 336 (1940).

The Decision of the Court Below Is Squarely and Directly In Conflict With the Decisions of the United States Court of Appeals for the Second Circuit in Kohnstamm v. Pedrick, 153 F. 2d 506 (C. C. A. 2d, 1945), and Cushman v. Commissioner, 153 F. 2d 510 (C. C. A. 2d 1946).

The Second Circuit has decided two cases dealing with the problem arising where managerial powers over trusts were reserved by the settlor, including the right to vote shares of stock of a closely held corporation in which the settlor was materially interested.

In the first of these, *Kohnstamm* v. *Pedrick,* 153 F. 2d 506 (C. C. A. 2d, 1945), the managerial powers reserved were considerably broader than those disclosed by the record in the instant case. In it, the settlor and his trust controlled thirty-one and one-half per cent of the voting strength of the corporation subject to control.[11]

In the second case, *Cushman* v. *Commissioner,* 153 F. 2d 510 (C. C. A. 2d, 1946), the powers of manage-

[11]In Kohnstamm v. Pedrick, 153 F. 2d 506 (C.C.A. 2d, 1945), the taxpayer transferred to the Farmers Loan & Trust Company of New York, as trustee, for the benefit of his wife and minor children, common stock of H. Kohnstamm & Co. Inc., a corporation in which he and his family had long been interested and of which he was vice-president at the time of the creation of the trust and, shortly thereafter, president. The income was to go to the wife for life and to the children until they reached twenty-five years of age and thereafter upon limitations not relevant. The settlor had the power to direct the trustee to apply to the use of the children part of the principal, if he wished. He was authorized to direct the trustee to make such sales and investments of the securities transferred as he thought best, and the trustee was required to comply and thus retain the property transferred until the settlor otherwise directed. The settlor also had authority to direct the trustee to vote the stock held in trust in such manner as he wished. He could also withdraw any securities from the fund provided he substituted property of equal value. The power was also reserved to the settlor "to modify or alter any of the provisions of this agreement relating to the Trustee, its power, authority, and responsibility with respect to the trust estate and the administration thereof;" and to revoke the appointment of the trustee and nominate any successor in its place,

ment were again broader than those found in the instant record and the shares in the trust fund, together with what the settlor owned individually, gave him forty per cent of the whole voting strength of the corporation.[12]

In both decisions it was held that retained managerial powers which could not be employed except in the best interests of the beneficiaries removed the cases from the scope of the philosophy behind the *Clifford* decision. This is especially true, the cases concluded, where, as in the case at bar, the combined voting stock of settlor and trust are not of significant proportions.

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provided it was a corporation authorized to do a trust business, with a capital of $1,000,000.

During the existence of the trust, Kohnstamm owned individually 11.0 per cent of the voting strength of the corporate stock and the trust, whose stock he had the right to vote, held 12.3 per cent. Thus Kohnstamm singly controlled the total of these two percentages, or 23.3 per cent of the total voting strength of the company. Kohnstamm held joint control over another 27.5 per cent of the company's voting strength by virtue of his appointment as trustee and committeeman of funds which held shares of stock of the corporation originally owned by members of Kohnstamm's family.

[12]In Cushman v. Commissioner, 153 F. 2d 510 (C.C.A. 2d, 1946), taxpayer created an irrevocable trust for the benefit of his children, with himself and his wife as trustees to last for the duration of the children's lives, with remainder to the children's descendants at their death. The corpus of the trust consisted of 20,000 shares of Class B stock of the American Bakeries Corporation, a company in which the settlor was a director and chairman of the Executive Committee. The purpose for creating the trust was two-fold; first, to put the property beyond the reach of the settlor's possible creditors and to assure an estate for his children, and, second, to preserve so much of the settlor's American Bakeries Corporation stock intact so that his son, if he wished, could at some time become associated with the corporation with the advantage of being a holder or beneficial owner of some of its stock. These two purposes, it should be noted, were exactly what motivated Mr. Schmidt to create the trusts in the case before the Court, T. R. 74-75, 78-80. It was in order to carry out the second purpose and to prevent the sale of the American Bakeries Corporation stock that the grantor named himself and his wife as trustees. He reserved to himself, *as grantor*, the power to control retention or sale of trust property and to direct investment or reinvestment of trust funds. The trustees at any time, as fully as if they were the individual owners of the securities held in trust, were empowered to participate in any capital readjustment of any corporations whose securities should be held in the trust.

A reading of these decisions leaves one with the positive conclusion that had the instant proceeding been heard by the Second Circuit, that court would have held the *Kohnstamm* and *Cushman* cases to be controlling.

But, the Sixth Circuit held this case to be controlled by its decision in *Shapero* v. *Commissioner,* 165 F. 2d 811 (C. C. A. 6th, 1948). In the *Shapero* decision, the court, speaking through the same judge which wrote the opinion below, stated that the Sixth Circuit was opposed to the holding of *Cushman* v. *Commissioner, supra,* and was in accord with the dissent in that case.[13] The conflict between the Circuits is, therefore, apparent on the face of the decisions.

Either the Sixth Circuit Court of Appeals or the Second Circuit Court of Appeals is right in its construction of the tax consequences of trusts similar to those in the *Kohnstamm, Cushman* and *Schmidt* cases. Both cannot be correct, because their decisions are irreconcilable. This conflict, we submit, presents an important problem in interpretation of our federal revenue laws which deserves the attention of this Court.

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[13] 165 F. 2d 811, 815.

Treasury Regulations Exempt the Settlor From Taxation On the Trust Incomes, But the Court Below Refused To Apply Such Regulations.

On January 28, 1946, the Commissioner of Internal Revenue promulgated regulations[14] which set forth a comprehensive scheme containing precise guides to the taxation of trust incomes in situations falling within the ambit of *Helvering* v. *Clifford*. These regulations were amended on August 4, 1947.[15] The regulations as amended (Treas. Reg. 111, Sec. 29.22(a)-21) are set forth in full in the Appendix to this brief.

At the time of the promulgations of the original and amended regulations, the Bureau of Internal Revenue issued accompanying mimeographs[16] which provided that in determining the taxability of trust incomes for years prior to January 1, 1946, the Bureau would act without reference to the regulations made by the Treasury Decisions. The mimeographs went on to state, however, that in cases not yet finally determined for such taxable years, it would be the policy of the Bureau, where no inconsistent claims prejudicial to the Government are asserted by trustees or beneficiaries, not to assert liability of the grantor under the provisions of Section 22(a) and the doctrine of *Helvering* v. *Clifford* if the trust income would not be taxable to the grantor under the new regulations.

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[14] T.D. 5488; 1946-1 Cum. Bull. 19.

[15] T.D. 5567; 1947-2 Cum. Bull. 9.

[16] Mimeograph 5968, 1946-1 Cum. Bull. 25, accompanying the original regulation and Mimeograph 6156, 1947-2 Cum. Bull. 13, accompanying the amended regulation.

It is submitted that under the new regulations the trust income was not taxable to the settlor.

The new regulations provide, in substance, that the doctrine of *Helvering* v. *Clifford* can be applied so as to tax income to the grantor in three general situations:

1. That situation in which the corpus or the income will, or may, return, after a relatively short term of years, to the grantor.
2. That situation in which the beneficial enjoyment of the corpus or the income thereof is subject to a power of disposition, whether by revocation, alteration or otherwise, exercisable by the grantor.
3. That situation in which the corpus or income of the trust is subject to administrative control primarily for the benefit of the grantor.

Each one of the three subdivisions are treated at length by the regulations, illustrations or examples being given of factual circumstances under which each would apply.

It is apparent at once that the first two situations are not applicable in the instant record. The question, therefore, is narrowed to whether under the third subdivision of the new regulations the grantor retained administrative control of the trust corpus *primarily* for his benefit.

In discussing the applicability of this subdivision of the regulations, it is provided that it shall be held that administrative control is exercisable *primarily* for the benefit of the grantor rather than the beneficiaries of the trust where:

1. The grantor has the right to purchase, exchange or otherwise deal with or dispose of the corpus or income for less than an adequate and full consideration.

The record here demonstrates that this situation did not exist and the district court so stated in its findings of fact.

2. The grantor has the power to borrow the corpus or income without adequate interest or without adequate security.

No such power is present in the grantor here.

3. The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including interest, before the beginning of the taxable year.

The facts demonstrate no such situation in this case.

4. The grantor has the right to exercise in a *non-fiduciary*[17] capacity the following powers:

   (a) A power to vote or direct the voting of stock or other securities;

   (b) A power to control the investment of trust funds; or

   (c) A power to reacquire the corpus by substituting other property of an equivalent value.

The settlor had no such power as is outlined in (c) above, but he did retain the powers referred to in (a) and (b). The question to be determined, there-

[17]Italics supplied.

fore, is whether these powers were held in a *nonfiduciary* capacity. If they were, under the new regulations the settlor is taxable on the income. If they were not, he is not taxable and under the mimeographs no tax should be asserted against him.

The new regulations lay down the following test to guide one in determining whether powers are held in a nonfiduciary capacity:

> "If a power is not exercisable by a person as trustee [the situation here], the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. * * * Where the trust corpus consists of stock or securities of a closely-held corporation, [a power with respect to such stock] may or may not, depending upon all the facts, be considered exercisable in a fiduciary capacity."

What are the "terms of the trust" and the "circumstances surrounding its creation and administration" in this case? The record establishes beyond question that the settlor retained managerial powers over the property of the trusts solely because of his superior knowledge of the affairs of the Coca-Cola Bottling Company, whose stock comprised the trusts' only asset, and that such powers were exercisable solely for the best interests of the trusts and not for any selfish interests of the settlor.[18] Where powers have been retained by a settlor because of some special talent or

[18] T. R. 132, 133.

peculiar source of knowledge held by the settlor, such powers are held to be exercisable *only* in a fiduciary capacity. 2 Scott, Trusts (1939), Section 185.

In *Cushman* v. *Commissioner,* 153 F. 2d 510 (C. C. A. 2d, 1946), the court stated:

> "The powers held as trustee are, of course, held in a fiduciary relationship and must be exercised only in the best interests of the beneficiaries. The power to vote the stock held in trust may not be exercised by the trustee for his own purposes; and where such conduct is threatened, a court of equity will direct the voting of the stock. See 2 Scott Trusts (1939), §193.1. It is a question of interpretation whether or not the powers reserved as grantor are held in a fiduciary capacity or for the grantor's own purposes. Ordinarily, they are held in a fiduciary capacity, and have been reserved only because of some special talent or particular source of knowledge of the grantor. *If they have been so reserved, the exercise of them is subject to court scrutiny.* Phipps v. Com'r, supra; but if they have been reserved by the grantor for his own purposes, they are subject to no control in their exercise. Com'r v. Branch, supra; cf. Helvering v. Stuart, 317 U. S. 154, 63 S. Ct. 140, 87 L. Ed. 154; see Scott, op. cit., supra, at §185. From the grantor's purpose as found by the Tax Court, it seems certain that the powers this petitioner retained as grantor were retained in a fiduciary capacity." (Italics supplied.)

It may be seen from these authorities, therefore, that the terms of the trusts and the circumstances surrounding their creation (the test provided in the

Treasury's regulations) demonstrate beyond question that the managerial powers retained by the settlor were held solely in a *fiduciary* capacity. Accordingly, under the regulations no tax liability to the settlor is indicated.

We submit that this Court should determine whether the regulations and the mimeographs promulgated in connection with them do or do not, as a matter of law, apply to tax years prior to their promulgation. The operative effect of these regulations and mimeographs should be determined by this Court. If they are applicable retroactively, then it should be determined that the settlor here is not taxable on the income of the trusts.

V.

CONCLUSION.

We submit that this Court should pass upon the serious questions here presented. These questions transcend private interest. They concern every individual who has created or may in the future create trusts for the benefit of members of his family. If the taxpayer is held liable for taxes on the income of the trusts here involved, a way has been opened to vitiate all family trusts in which a settlor-father gives the advantage of his experience and knowledge regarding trusteed property. We submit that taxation on the income of property cannot be constitutionally imposed on such a basis.

It is, therefore, respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers by granting a writ of certiorari and reversing the decision of the United States Court of Appeals for the Sixth Circuit.

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APPENDIX.

Internal Revenue Code:

Sec. 22. *Gross Income.*

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. 1946 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.22(a)-21. *Trust income taxable to the grantor as substantial owner thereof.*

(a) *Introduction.*—Income of a trust is taxable to the grantor under section 22 (a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligations if he has retained a control of the trust so complete that he is still in practical effect the owner of its income. *Helvering* v. *Clifford,* 309 U. S. 331. In the absence of precise guides supplied by an appropriate regulation, the application of this principle to varying and diversified factual situations has led to considerable uncertainty and confusion. The provisions of this section accordingly resolve the present difficulties of application by defining and specifying those factors which demonstrate the retention by the grantor of such complete control of the trust that he is taxable on the income therefrom under section 22 (a). Such factors are set forth in general in paragraph (b) and in detail in paragraphs (c), (d) and (e), below.

(b) *In general.*—In conformity with the principle stated in paragraph (a) above, the income of a trust is attributable to the grantor (except where such income is taxable to the grantor's spouse or former spouses under section 22 (k) or 171) if—

(1) the corpus or the income therefrom will or may return after a relatively short term of years (see paragraph (c));

(2) the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (other than certain excepted powers), whether by revocation, alteration or otherwise, exercisable by the grantor, or another person lacking a substantial adverse interest in such disposition, or both (see paragraph (d)); or

(3) the corpus or the income therefrom is subject to administrative control, exercisable primarily for the benefit of the grantor (see paragraph (e)).

(c) *Reversionary interest after a relatively short term.*—Income of a trust is taxable to the grantor where the grantor has a reversionary interest in the corpus or the income therefrom which will or may reasonably be expected to take effect in possession or enjoyment—

(1) within 10 years commencing with the date of the transfer, or

(2) within 15 years commencing with the date of the transfer if the income is or may be payable to a beneficiary other than a donee described in section 23 (o) and if any one or more of the following powers of administration over the trust corpus or income are exercisable solely by the grantor, or spouse (living with the grantor, and not having a substantial adverse interest in the corpus or income of the trust), or both, whether or not exercisable as trustee: a power to vote or direct the voting of stock or other securities, a power to control the investment of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a

power to reacquire the trust corpus by substituting other property, whether or not of an equivalent value.

Where the grantor's reversionary interest is to take effect in possession or enjoyment by reason of some event other than the expiration of a specific term of years, the trust income is nevertheless attributable to him if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be. For example, a grantor is taxable on the income of a trust if the corpus is to return to him or his estate on the graduation from college or prior death of his son, who is 18 years of age at the date of the transfer in trust. Trust income is, however, not attributable to the grantor where such reversionary interest is to take effect in possession or enjoyment at the death of the person or persons to whom the income is payable.

In general, a reversionary interest may reasonably be expected to take effect in possession or enjoyment within 10 or 15 years, as the case may be, where the corpus or the income therefrom is to be reacquired if the grantor survives any stated contingency which is of an insubstantial character. Thus, the grantor is taxable where the trust income is to be paid to the grantor's wife for three years, and the corpus is then to be returned to the grantor if he survives such period, or to be paid to the grantor's wife if he is already deceased.

Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. But income for any period shall not be taxable to the grantor by reason of the preceding sentence if such income would not be taxable to him in the absence of such postponement.

EXAMPLE: A places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to A or his estate. Neither A nor his wife has any power of administration over the trust corpus or income. After the expira-

tion of nine years A extends the terms of the trust for an additional two years. A is considered to have made a new transfer in trust for a term of five years. He is not taxable on the income for the first three years of such term because he would not be taxable thereon if the term of the trust had not been extended. A is taxable, however, on the income for the remaining two years.

(d) *Power to determine or control beneficial enjoyment of income or corpus*—Income of a trust is taxable to the grantor where, whatever the duration of the trust, the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition (except as provided in section 167 (c) and as hereafter provided in subparagraphs (1) to (4), inclusive), whether by revocation, alteration, or otherwise, exercisable (in any capacity and regardless of whether such exercise is subject to a precedent giving of notice or is limited to some future date) by the grantor, or any person not having a substantial adverse interest in the beneficial enjoyment of the corpus or income, whichever is subject to the power, or both. The grantor is not taxable, however, if the power, whether exercisable with respect to corpus or income, may only affect the beneficial enjoyment of the income for a period commencing 10 years from the date of the transfer (or 15 years where any power of administration specified in subsection (c) is exercisable solely by the grantor, or spouse living with the grantor, and not having a substantial adverse interest, or both, whether or not as trustee). For example, if a trust created on January 1, 1940 provides for the payment of income to the grantor's wife, and the grantor does not reserve any such administrative power but reserves the power to substitute other beneficiaries in lieu of his wife on or after January 1, 1950, the grantor is not taxable on the trust income for the period prior to January 1, 1950. But the income will be attributable to the grantor for the period beginning on such date unless the power is relinquished. If the beginning of such period is postponed, such postponement is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. But income for any period

shall not be taxable to the grantor by reason of the preceding sentence if such income would not be taxable to him in the absence of such postponement. Where the income affected by the power is for a period beginning by reason of some event other than the expiration of a specific term of years, the grantor will be taxable if such event is the practical equivalent of the expiration of a period less than 10 or 15 years, as the case may be, in accordance with the criteria stated in paragraph (c).

The foregoing provisions of this paragraph shall not apply to any one or more of the following powers:

(1) a power exercisable only by will, other than a power in the grantor to appoint the income of the trust where the income is accumulated for such disposition by the grantor, or may be so accumulated in the discretion of the grantor, or any person not having a substantial adverse interest in the disposition of such income, or both. For example, if a trust provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will, the grantor is taxable on the trust income;

(2) a power to determine the beneficial enjoyment of the corpus or the income therefrom if such corpus or income, as the case may be, is irrevocably payable for the purposes and in the manner specified in section 23 (o);

(3) If (i) the power is exercisable by a trustee or trustees, none of whom is the grantor, spouse living with the grantor, or a related or subordinate trustee of the type and under all the conditions referred to in subparagraph (4) (ii), and (ii) the exercise of the power is not subject to the approval or consent of any person other than such trustee or trustees, this paragraph shall not apply to a power—

(A) to distribute, apportion or accumulate income to or for a beneficiary or benficiaries, or to, for, or within a class of beneficiaries,

(B) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

The powers herein described include all the powers described in subparagraph (4), since the latter powers are more limited than those herein described.

(4) If the power—

(i) is exercisable by the grantor or spouse living with the grantor, or both, whether or not as trustee, or

(ii) is exercisable (A) solely by a trustee or trustees who include the father, mother, issue, brother, sister, or employee of the grantor, or a subordinate employee of a corporation in which the grantor is an executive or in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control, and (B) in a manner which may affect the interests of beneficiaries which include the spouse or any child of the grantor (see subparagraph (3) for a power exercisable by a related or subordinate trustee of the class hereinabove described where the exercise of the power does not affect the interest of the spouse or a child of the grantor or where the power is exercisable only with the concurrence of an unrelated and non-subordinate trustee), or

(iii) is exercisable by any person or persons other than as trustee, or

(iv) is exercisable by any trustee or trustees, and the exercise of the power is subject to the approval or consent of any person or persons (other than such trustee or trustees), or of the grantor or spouse living with the grantor, or both in the capacity of trustee,

this paragraph shall not apply—

(aa) to a power to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries),

provided that the power is limited by a reasonably definite external standard. Such standard must be set forth in the trust instrument and must consist of needs and circumstances of the beneficiaries;

(bb) If the power is not limited by a reasonably definite external standard, to a power to pay out corpus to or for any current income beneficiary, provided that any such payment of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to such beneficiary as if such corpus constitutes a separate trust;

(cc) to a power to distribute or apply income to or for any current income beneficiary or to accumulate such income for him, provided that any accumulated income must ultimately be payable to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors or the creditors of his estate; or, if payable upon the termination of the trust or in conjunction with a distribution of corpus which distribution is augmented by such accumulated income, is ultimately payable to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which may reasonably be expected to occur within the beneficiary's lifetime, the share of such deceased beneficiary is to be paid to such persons as the beneficiary may appoint, or is to be paid to one or more designated alternate takers (other than the grantor or the grantor's estate) if the share of such alternate taker or the shares of such alternate takers have been irrevocably specified in the trust instrument;

(dd) to a power, exercisable only during (*1*) the existence of a legal disability of any current income beneficiary, or (*2*) the period in which any income beneficiary shall be under the age of twenty-one years, to distribute or apply income to or for such beneficiary or to accumulate and add such income to corpus;

(ee) in a case falling under subdivision (ii) hereof, to a power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions in subdivision (cc) or (dd) are satisfied, provided that such power is limited by a reasonably definite external standard. For the requirements of such standard, see subdivision (aa) hereof.

A power does not fall within the powers described in subparagraphs (3) and (4) if the trustee is enabled to add to the class of beneficiaries designated to receive the income or corpus, except in so far as provision may be made for after-born or after-adopted children. A mere power to allocate receipts as between corpus and income, even though expressed in broad language, is not deemed a power over beneficial enjoyment with respect to income or corpus.

(e) *Administrative control.*—Income of a trust, whatever its duration, is taxable to the grantor where, under the terms of the trust or the circumstances attendant on its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Administrative control is exercisable primarily for the benefit of the grantor where—

(1) a power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor or any person to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate and full consideration in money or money's worth; or

(2) a power exercisable by the grantor, or any person not having a substantial adverse interest in its exercise, or both, whether or not in the capacity of trustee, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest in any case, or without adequate security except where a trustee (other than the grantor or spouse living with the grantor) is authorized under a general lending power to make loans without security to the grantor and other persons and corporations upon the same terms and conditions; or

(3) the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year; or

(4) any one of the following powers of administration over the trust corpus or income is exercisable in a nonfiduciary capacity by the grantor, or any person not having a substantial adverse interest in its exercise, or both: a power to vote or direct the voting of stock or other securities, a power to control the investments of the trust funds either by directing investments or reinvestments or by vetoing proposed investments or reinvestments, and a power to reacquire the trust corpus by substituting other property of an equivalent value.

If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether such power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. For example, where the trust corpus consists of diversified stock or securities of corporations the stock of which is not closely held and in which the holdings of the trust, either by themselves or in conjunction with the hold-

ings of the grantor, are of no significance from the viewpoint of voting control, a power with respect to such stocks or securities held by a person who is not a trustee will be regarded as exercisable in a fiduciary capacity primarily in the interests of the beneficiaries Where the trust corpus consists of stock or securities of a closely-held corporation, such a power may or may not, depending upon all the facts, be considered exercisable in a fiduciary capacity.

The mere fact that a power exercisable by the trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth, or is authorized to lend the trust property or income to the grantor without adequate interest. On the other hand, such authority may be indicated by the actual administration of the trust.

(f) *Limitations of section.*—Despite the limitations of this section, the grantor of a trust directing the payment or application of the income therefrom in satisfaction of the grantor's legal obligations shall continue to be taxable on the income. The grantor may also be taxable on the income of a trust on the ground that such income is attributable to him in a capacity unrelated to dominion and control over the trust as such are defined in subsections (c), (d) and (e) of this section. Thus, the provisions of this section do not affect the principles governing the taxability of future income to the assignor thereof whether or not the assignment is by means of a trust. Nor, for example, do the provisions of this section affect the applicability of section 22 (a) to the creator of a family partnership. See further sections 166 and 167.

Section 22 (a) shall be applied in the determination of the taxability of trust income for taxable years beginning prior to January 1, 1946 without reference to this section.